

# **Capital Markets in Developing Countries: USAID Experience and Insights**

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(RTI Task No. 6598-06)

October 1997

Environmental and Urban Programs Support Project  
Contract No.: PCE-1008-I-00-6005-00  
Project No.: 940-1008  
Contract Task Order No. 06  
Sponsored by the Office of Environment and Urban Programs (G/ENV/UP)  
U.S. Agency for International Development  
Washington, DC 20523

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## **Laying the Groundwork**

Since its inception, the U.S. Agency for International Development (USAID) has worked in developing countries to alleviate poverty, empower citizens, and improve the quality of life, by supporting the provision of basic services, such as housing, health care, and education and the development of systems that contribute to environmental improvement and economic growth such as energy and municipal infrastructure. From this work has grown an increased understanding of the important role that capital investment plays in making sustainable many of the gains originally accomplished through official development assistance from multilateral and bilateral donors.

Yet USAID has learned that whether demanded by the citizens through the public sector or by the private sector, capital investment cannot be put in place in developing economies unless the legal and financial systems exist that provide adequate security for the delivery of financial resources, and allow financing and privatization to proceed efficiently and economically. Moreover, without these systems, the private economic activity that creates much of the demand for this investment also will not thrive.

Summarized below, and in the attached case studies, are some examples of USAID's activities in privatization and capital markets development in a number of emerging economies. To date, USAID has initiated policy reforms, provided resources to raise the capacity of local institutions and carried out model projects to demonstrate how private investment aids development, thereby laying the groundwork for expanded investment efforts.

But to fully capitalize on this foundation, USAID now sees the need, in many countries, to enter into a more transaction-oriented phase of development. While reforms are still needed, to improve the conditions for investment, only if financial transactions can be efficiently carried out can we judge that the policy and institutional reforms promoted by USAID have fully succeeded. To move more decisively in this direction, the expertise and support of the U.S. private sector is essential. Private sector collaboration with USAID can not only strengthen the results of USAID's activities internationally, but can simultaneously create opportunities for American expertise in privatization and private finance overseas.

The attached summaries describe some of the support USAID has provided to date around the world to improve private financing systems. We hope this information can

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serve as the basis for an expanded dialog between USAID and those in the private sector who have benefitted from the work we have been doing, or could benefit in the future. USAID would like to be seen as a partner of those in the U.S. interested in expanded capital finance in developing countries. This information is offered as an invitation to a range of parties to enter into a more earnest dialog with USAID about how partnerships with the private sector, based on the shared goal of increasing investment, can be built and expanded in the future.

## **The Results of Reform**

USAID programs have helped facilitate financial and capital market development by working directly on the creation or reform of financial institutions and intermediaries involved in raising and trading capital. USAID has also supported the implementation of capital market development through privatization and enterprise restructuring, municipal finance strengthening, housing finance, and legal and regulatory reform. A few recent have had an impact on financial market development worldwide.

has been USAID's experience that to ensure the best results from privatization, capital Eastern Europe supported by USAID has focused primarily on equity investment, although g systems have been developed to handle all types of securities. Beginning in 1989 with Support Act, USAID assisted privatization efforts in many former Soviet-block countries by firms). USAID activities have aided exchange operations, including stock exchanges, over-the-counter institutions.

Throughout have also assisted in transforming former state-owned enterprises into competitive market-businesses. Business Advisory Centers, which provide financial resources as well as Macedonia, Slovakia, Romania, Moldova and Hungary. The decision to privatize housing lending institutions in Russia, and USAID has assisted these efforts.

In investment in municipal infrastructure, the result of rapid urbanization in the region. Local national governments are looking beyond traditional "pay-as-you-go" and official development options for long-term private sector financing. USAID has supported private capital in municipal infrastructure in India, the Philippines and Indonesia, by facilitating

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municipal bond market development and the establishment of credit rating systems for municipalities. Additionally, USAID has provided assistance in stock market development in Indonesia and Sri Lanka. Due to assistance provided by USAID, the Colombo Stock Exchange increased the efficiency of its clearing and settlement systems and was able to handle the increases in trading that began after 1994, as that economy grew. These initiatives have not only helped Asian countries improve the living conditions and productivity of their citizens, but they have also encouraged the increasing integration of these countries into the global marketplace.

USAID programs of legal and regulatory reform in many countries have improved conditions for finance and investment. For example, in Costa Rica, collaboration with local counterparts on the regulation and supervision of state and private banks resulted in the institution of a new banking law in 1996, which provided more autonomy for banks and greater competition in the banking sector. As a part of USAID assistance in commercial law development in Bulgaria, Poland and Lithuania, local law professionals learned to analyze and perform commercial law transactions as well as reform commercial laws to bring them more in line with international standards.

In 1996, the Polish Securities Commission, with assistance from USAID, completed new municipal securities disclosure regulations and issued model disclosure documents. In Kenya, USAID helped to revise policies affecting export development, and worked to strengthen financial sector institutions. These include the Kenyan Capital Markets Authority which has developed, and is enforcing, capital markets regulations, and the Nairobi Stock Exchange, which grew considerably, in terms of outstanding shares and trading volume, during the period of USAID's assistance between 1988 and 1994.

## **The Opportunity for Partnership**

These are just a few examples of USAID's activities in strengthening financial and capital markets and conditions for private investment. USAID has learned that improving financial systems and market conditions plays a major role in a country's capacity to develop and become integrated into the global economy. USAID believes that the technical expertise it has gained, as well as the insights it has acquired about the objectives of government decision-makers around the world, represent a significant asset to U.S. firms who are seeking investment opportunities in emerging markets. And USAID believes that its future work in these areas should reflect the experience and concerns of these private organizations.

The attached case studies detail some of USAID's activities in financial and capital markets development and privatization in a number of emerging economies. We hope these summaries will contribute to a better understanding of USAID's role overseas, and, as a result, help advance the dialog between USAID and those in the private sector who find value in the work we do.

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# ***USAID Case Study***

## **Costa Rica/Central America**

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### **Economic Context**

Following economic hardship in the 1970s caused by expansionary domestic policies, an overvalued exchange rate and deteriorating terms of trade, Costa Rica in the 1980s introduced dramatic changes in the economy. Since 1982, the Government of Costa Rica has placed considerable emphasis on improving the investment climate, and has enjoyed the fastest economic growth in Latin America for more than a decade. Although Costa Rica still suffers from a comparatively large fiscal deficit, the government recently reduced total external debt under an agreement with commercial bank creditors.

State banks largely dominate the banking sector, holding 79 percent of the formal sector assets as of 1989, and still account for more than half of the total assets of the formal financial sector, although changes in policies and the banking law have ended the government monopoly on basic banking functions. Private banks are growing in number and are increasing their market share by employing innovative lending techniques and operating in a more efficient manner. Foreign direct investment increased dramatically in the 1990s, reaching \$355 million in 1995.

### **Role of USAID**

USAID assistance in the Costa Rican financial sector intensified during the 1980s in response to the local economic situation of large budget and balance of payments deficits and expansionary monetary policies. USAID, at times in collaboration with other donors, undertook programs to reduce the state's role in the economy in finance, production, and regulation, and worked towards increasing public sector efficiency and decreasing the fiscal deficit. In the early 1980s, USAID supported Costa Rica's launching of the private financial sector, creating an environment in which at least 24 privately held banks now operate. USAID also helped to improve the policy and regulatory environment and introduced improved management techniques in order to modernize the financial sector. In the 1990s, USAID programs helped increase access of individuals to financial services as a means of expanding local savings, investment and economic growth. Costa Rica recently "graduated" from USAID assistance due to successful programs and reforms which have produced a living standard comparatively high within Central America, and increasingly effective public service delivery.

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## USAID-Supported Accomplishments in Finance and Privatization

### Banking Sector

Provided technical assistance that resulted in a more efficient and competitive commercial banking sector through policy, procedural and institutional reform of banks and financieras. Also assisted with reform of the stock exchange. (1992-1993)

Assistance given in improving credit union (CU) supervision and systems development, producing increased membership and savings. Assistance with policy reform and management, and with establishment of a central liquidity facility. Development of norms and procedures for CU operations. (1990-1994)

Private banks were given the right by the Costa Rican government to accept demand deposits, as the result of assistance provided by USAID in the early 1980s. (1996)

### Privatization

Supported restructuring of government support of the agricultural sector and enhancement of private sector productivity.

### Legal and Regulatory Reform

Technical assistance provided for modernization of customs services. (1990-1994)

Helped to create export development programs including the Export Development Foundation, resulting in an annual increase in measurable exports of \$5 - \$7 million for each \$1 million invested. (1990-1995)

Assisted in drafting the laws regulating financial intermediation activities (now enacted). (1990-1994)

Collaboration with the Auditor General on bank regulation and supervision including redrafting of the Costa Rican banking law, providing more autonomy for banks and broader powers for a Superintendent General for Banking. Assisted government in better managing offshore banking activities and liberalizing the financial sector. The Financial Sector Reform Law went into effect in 1996.

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# **USAID Case Study**

## **India/Asia**

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### **Economic Context**

Elements of the capital market have been in operation in India for more than a century, although only recently has the securities market expanded and become an increasingly important source of capital for the corporate sector. Today, both the equity and debt components of the market continue to grow, but the market capitalization for debt has historically been low because of a regulatory environment that has rendered private sector debt instruments unattractive to investors. In 1991, the Government of India (GOI) introduced a liberalization policy which initiated movement towards a more open, market-based economy attracting more private sector participation, including foreign investors. As a result of these reforms, the financial sector is subject to less explicit price controls and directed lending and has substantially simplified price regulation, all of which allows financial institutions to take on greater risk. In terms of its macroeconomics, the GOI set a goal 6-7 % annual growth while reducing the combined fiscal deficit. During 1995, \$2 billion of U.S. investment was approved in India (the largest single source of foreign direct investment), accounting for approximately 20 percent of total investment approved that year.

### **Role of USAID**

USAID has actively supported the efforts of the GOI to liberalize the economy, make financial services more available to citizens and organizations, increase financial market efficiencies and promote economic growth through private sector development. Shortly after the economic changes introduced by the GOI in 1991, USAID identified three principal objectives for its assistance: promotion of an improved financial and regulatory environment; increases in the productivity of Indian enterprises; and encouragement of smaller, healthier families. USAID has worked extensively with local institutions and community development organizations to develop the housing finance system. Recently, USAID has helped the GOI expand and strengthen the Indian debt and equity markets through reform and improvements in the capacity of local governments to finance infrastructure projects.

### **USAID-Supported Accomplishments in Finance and Privatization**

#### **Debt/Equity Market**

Support in establishing a national securities depository system. The system, which began functioning in November 1996, provides a paperless approach to trading on the national exchange. The 23 regional stock exchanges will be developing clearing corporations to settle trades in the national securities depository. (1994-96)

To encourage automation of trading systems, USAID helped create a program to assure that newly automated exchanges would be compatible,

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	<p>allowing transactions between stock exchanges. Both the Bombay and the National stock exchanges were fully automated, along with several regional exchanges. (1994-1996)</p>
Housing Finance	<p>Support for development of the Housing Development Finance Corporation, which has become a major actor in housing finance and in the Indian financial system. HDFC is one of the largest term-lending institutions in India and a largely self-reliant financial intermediary. (1989)</p> <p>Assistance establishing the National Housing Bank as India's apex housing finance institution as well as the primary regulatory and supervisory agency for housing finance companies. The creation of the NHB sparked interest in housing finance in the national financial community. (1988-1992)</p>
Privatization/ Commercialization	<p>Establishment of the Program for the Advancement of Commercial Technology fund which improved the pace and quality of technological innovation in the private sector by promoting and financing over 30 Indo-U.S. joint venture projects. (1987-1992)</p> <p>Contribution to improving the technical and managerial capacities of private sector enterprises, thereby increasing productivity and profitability, and saving or creating jobs, upgrading technologies and making small and medium-sized private companies more responsive to market demands. (1990-1994)</p>
Municipal Finance	<p>Successful collaboration with CRISIL, leading Indian rating agency, to develop methodology for rating municipalities, subsequently used to rate several Indian cities. Ahmedabad Municipal Corporation received an A+ credit rating, an important step towards the municipality's goal of floating a municipal bond in the India capital market. Bonds are establishing a new option in public finance, providing local governments access to the capital markets. (1994-1996)</p> <p>Cooperated with GOI to improve urban resource management by decentralizing municipal services from central and state to local governments, increasing the role of private sector in the delivery of public services and improving the capacity of municipalities to plan and provide services. (1992-1993)</p>
October 1997	

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# **USAID Case Study Indonesia/Asia**

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## **Economic Context**

Indonesia has a centralized but primarily stable economy moving towards greater decentralization and privatization. During the early 1980s, the government of Indonesia (GOI) launched a reform program which removed a number of obstacles to private sector development and reduced the country's dependence on petroleum for revenue. Indonesia has benefitted from relatively low rates of inflation since the late 1980s and the private sector now plays a larger role in the economy. The GOI actively encourages foreign investment as a way to meet the needs of the burgeoning infrastructure requirements while limiting public indebtedness.

A 1988 deregulation package opened banking, securities and insurance industries to foreign investment. In June 1994, and again in May 1995, previously restricted sectors were opened to foreign investment, including: harbors, electricity generation, telecommunications, shipping, airlines, railways, and water supply and provision. Government policy supports increasing decentralization of government and privatization of municipal infrastructure. For 1995, the estimated total of U.S. direct investment in Indonesia was \$4.6 billion.

## **Role of USAID**

USAID has a long history of activities in Asia and maintains a strong presence in Indonesia. A number of projects undertaken by the government of Indonesia with USAID assistance have focused on addressing weaknesses in the Indonesian financial markets, including stock and bond markets, municipal finance, and the commercial banking sector. Projects have focused on reform of state-operated banks and private financial institutions in both urban and rural areas. While the momentum for financial sector development and reform has come from a number of sources in Indonesia, USAID has contributed to it through several successful programs.

## **USAID-Supported Accomplishments in Finance and Privatization**

### **Legal and Regulatory Reform**

Collaboration on creation and implementation of new operational infrastructure has increased stock market efficiency and public confidence. The Capital Market Executive Board (BAPEPAM) is now an independent regulatory agency, separate from the stock exchange and clearing corporation, able to draft and implement rules and work effectively with market institutions. (1988-1995)

Assistance with preparation of privatization policies for

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Privatization	selecting Initial Public Offerings (IPO) candidates and intermediaries. Improved the capacity within the Ministry of Finance Directorate of State Owned Enterprises to carry out privatization activities. (1988-1995)
Capital Market	Provided support in developing a new credit rating agency and new commercial regulations as well as a new system for auctioning money market securities. (1988-1995)
Financial Sector	Assisted in improving in Bank of Indonesia's institutional capabilities and its relationships with central bankers in the ASEAN region and globally, in part due to the development of an electronic funds transfer system.
	Assistance to Bank Rakyat Indonesia (BRI) on interest rate and other policies, the design of credit instruments and training. Support in modernizing BRI's banking functions.
Debt Market	Technical support on development of the secondary mortgage market, including drafting of a prospectus and development of operating procedures. (1993-1997)
Municipal Finance	Assistance in identification and development of stable institutional sources of domestic credit through which municipalities can borrow, including the Regional Development Account and municipal bonds. (ongoing)
	Assistance with the development of credit rating criteria for municipal revenue bonds.
	Collaboration in enhancement of municipal financial management, including improving local own-source revenues and accelerating the privatization of municipal infrastructure. (1988-1997)

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## **USAID Case Study**

# **Poland/Eastern Europe**

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### **Economic Context**

In late 1989, the Polish government introduced macroeconomic stabilization and liberalization measures and, shortly thereafter, accelerated reforms. By the early 1990s, Poland had created the basic operating features of a market economy, albeit a fragile one. During the same period, the economy grew at a fast rate due to widespread privatization. The budding capital market has been dominated by the national government's debt instruments, with some influence from the newly formed equities markets centered in the Warsaw Stock Exchange. There has been increased activity in the municipal bond market, and both debt and equity market mechanisms are improving. Poland remains one of the fastest growing economies in Europe with projected increases in the GDP of over 5% annually through the end of the decade.

### **Role of USAID**

Since the reform process began in Eastern Europe in the late 1980s, Poland has received USAID technical assistance primarily focused on private sector development. USAID's goal in Poland is to assist in that country's transformation to democracy and a market-oriented economy through economic stabilization and institutional restructuring. Poland is scheduled to graduate from USAID assistance within the next few years due to the marked success of the Polish reform programs and the stability of its economy. USAID assistance now focuses on supporting capital markets development as well as ensuring the long-term viability of the institutions and innovations recently put in place in the financial sector.

### **USAID-Supported Accomplishments in Finance and Privatization**

#### **Legal and Regulatory Reform**

Improvements in the capacity of local professionals to analyze and perform commercial law transactions. Assisted in commercial and collateral law reform to provide security interest in property thereby fostering commercial lending. (1994)

Advising on policy issues related to intergovernmental finance, local government revenue authority and legal impediments to cost recovery for municipal infrastructure through training of government officials. (ongoing)

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Privatization	Assistance to the Ministry of Privatization related to National Investment Funds, share trading and distribution practices, corporate finance and mergers and acquisitions. (1993-1996)
Banking Sector	Support for the development of a sound, efficient and market-oriented financial sector by completion of an inspection manual for bank supervisors and strategic planning materials for financial institutions. Strengthening of corporate finance capabilities in major Polish banks. (ongoing)
	Assistance with institutionalizing methodologies for municipal infrastructure project appraisal and municipal credit worthiness analysis by commercial banks. (ongoing)
Equity Market	Supported development of the Securities Commission and the over-the-counter market. (1996)
	Technical assistance to separate the depository from the Warsaw stock exchange and to improve clearance and settlement procedures.
Municipal Finance	Introduction of new practices to facilitate long-term planning by municipalities for financing of capital investment projects. Establishment of the municipal bond market and related institutions. (1994-1997)
	Assistance in developing model disclosure guidelines for municipal bond issues, approved in November 1996 by the Polish Securities Commission for general use by Polish cities. (1996)

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